BUSINESS CREATION – RECORDKEEPING – TAXATION

(A Small Business Support Perspective)

Wilson Louis-Elias

2007

P. O. Box 14202

Hauppauge NY 11788

Tel: (631) 676-2282

www.pctouchservices.com

Disclaimer

Information presented here is not a substitute for legal advice and is as current as the time of publication. Readers still have to seek professional help for more specific business advice.

P. O. Box 14202
Hauppauge NY 11788
Tel: (631) 676-2282
www.pctouchservices.com

About Wilson Louis-Elias

In 1994, Louis-Elias relocated from Brooklyn to Elmont, New York. He attended CUNY-York College for one semester and returned to CUNY-Medgar Evers College. His brief attendance there allowed him to begin his accounting career with his Accounting 102 teacher - Edwin Angerville.

The teacher introduced himself to the class as the owner of a small CPA firm in Queens. Louis-Elias grabbed the opportunity and volunteered to work for him. Upon his teacher's acceptance, Louis-Elias joined Edwin Angerville, CPA in late 1994. In 1996, he left the former teacher and opened his accounting firm in Valley Stream. Two years later, he was practicing in Brooklyn, New York, and Elizabeth, New Jersey. Both offices provided bookkeeping and tax services to small businesses and individuals.

In June 1999, Wilson Louis-Elias stopped servicing the private sector to join New York State Department of Taxation and Finance (NYS DTF). He conducted tax audits of a large number of individuals, and small and mid-size companies - sole proprietorships, partnerships, corporations, and LLCs - at the Nassau District Office for four years. In 2003, the district office manager - Susan King - granted him a transfer to join the Suffolk District office of NYS DTF where he worked for John Thomas under the management of Albert Coringrato until February 2006.

Wilson Louis-Elias left the NYS DTF to eliminate a ban there for every tax auditor. As tax auditors, NYS DTF auditors screen tax returns filed with the department to determine whether further examination should be conducted. Determinations on audits were reached based upon New York State tax laws and/or Internal Revenue Codes and examination of accounting records. As a result, tax auditors were barred from performing accounting and tax works for the private sector. Leaving NYS DTF allowed Louis-Elias to return to private practice in 2006.

In the meantime, Mr. Louis-Elias attended University of Phoenix and obtained his master of science in computer information systems (MS-CIS). Also, to represent his clients and expand his practice, Louis-

Elias became an enrolled agent (EA) admitted to practice before the Internal Revenue Service (IRS).

BUSINESS CREATION – RECORDKEEPING – TAXATION

Introduction

New business owners entering the marketplace want to bring one or more products or services to consumers. To bring their products or services to consumers, new business owners have to face obstacles such as determining business location, competitions, etc. In addition, they face the challenge of handling mount of paperwork in creating a company, keeping and maintaining records, and dealing with taxation. Although challenging, paperwork has to be handled properly to avoid its devastating impact on the future of the new company. To assist new small business owners, we will discuss each one of those steps from a small business support perspective.

Business Creation

The question about what type of business entity to create can be answered differently depending on the products and/or services one plans to offer to consumers. It also depends on how much personal liability the owner is willing to carry in the event that the company cannot deliver on its promises. At last, but not least, local and state governments may require a particular type of business entity for one reason or another. Then, the entrepreneur has no other options but to abide by such governance.

In the next subsections, we will briefly discuss some of the most common types of business entities to help understand them.

Sole Proprietorship

A sole proprietorship is a type of business entity that one person owns. It is regarded as the most attractive type of business entity for its low initial investment requirement. A sole proprietorship can be created within one day to say the most for a very motivated person. If the owner opts to use his or her own name as the business name, there is no requirement to register the company. If the sole proprietor plans to use an assumed name, then the latter name must be registered.

Tax agencies require no separate tax return for the owner and this type of business entity. The business tax return is filed on schedules attached to the owner's personal tax return. As far as liability is concerned, the general public makes no difference between the company and the owner. In addition, the owner cannot be an employee of the company. However, the company can hire employees other than its owner.

Partnership

A partnership is a type of business entity that two or more people owned jointly. Partnerships' assets must be kept separate from partners' personal properties. The Internal Revenue Service (IRS), as well as New York Department of Taxation and Finance (NYS DTF), considers partnership as a separate entity from its owners. However, the general public, rightly so, disregards this separation for liability purpose. Partners are not employees of the partnership and it is not required to pay employment tax for them.

There are two types of partnerships: general and limited liability partnerships. Let us briefly discuss the two types of partnerships and their liability features.

General Partnership

In New York Sate, general partnerships are registered with the county where they are located. Like sole proprietorship, a general partnership must be registered in every county where it conducts business. Each partner shares the business' liability individually or severally. This means that creditors can collect the partnership's debt from one partner individually or all partners collectively. It is the responsibility of the partner who satisfies the debt, individually, to recover the portion paid for each partner.

Limited Liability Partnership

A limited liability partnership (LLP) differs somewhat from a general partnership. First, a New York LLP must be registered with New York State versus the county where it conducts business. As a result, an LLP is allowed to conduct business anywhere within the state's boundary. Partners are liable to outsiders according to their share of liability as stipulated in the partnership agreement.

Corporation

A corporation is a state business type of entity that is allowed to conduct business anywhere within the state. It can conduct business across the state border as well if it registers with that state. A corporation's name has to be unique within every state where it conducts business.

Most new entrants to the business arena wish to incorporate some days to benefit from the limited liability feature of corporation. The latter feature prevents debt collectors from pursuing shareholders for the corporation's debt. In the event the corporation looses its entire assets, shareholders (owners) will only loose up to the amount of their investment in the company.

There are two different types of corporations. The two types are referred to as General Business or C-Corporation and Subchapter S or simply S-Corporation. In the two subsections below, we will discuss the two types of corporations.

General Business Corporation

General Business Corporations have become less and less attractive to small business owners because of the double-taxation burden. Every year, a General Business Corporation files tax returns and pays a minimum or tax on profits. In addition, shareholders have to pay tax - at the individual level - on dividends received from the corporation. For large corporation, it is apparent that benefits such as ability to raise capitals beyond the border of this country outweigh the double-taxation burden. As a US Artificial Person, general business corporation's shareholders can be nationals of almost any country in the world.

S-Corporation

The Subchapter S Corporation, commonly known as S-Corporation, has been the attraction of small business owners. While the maximum number of shareholders is limited to 100, as few as one (1) US legal resident can own an S-Corporation. There is no double-taxation, per se, for the S-Corporation's shareholders. However, shareholders have to pay tax on net profit of the company. It is the responsibility of the owner to determine the amount of tax on such profit to report it on his or her personal tax return (IRS Form 1040). Whether the profit was actually distributed is irrelevant.

Limited Liability Company

Limited Liability Company (LLC) is very attractive to large business investors. Its owners are called members. LLC includes some of the features of sole proprietorship, partnership, and corporation. An LLC is a state-hybrid type of business entity that can have the characteristics of a sole proprietorship, partnership, and corporation for tax purpose. Regardless of those characteristics for tax purpose, an LLC is an artificial person and it is separate from its owners. Like LLP and corporation, LLC must be registered with the state, but under more rigid rules and stipulations. Following its organization, the LLC name must be published in two local newspapers in the county where its main office is located. Failure to do so in a timely fashion will suspend the existence of the LLC. The list of steps to take toward organizing an LLC continues to grow and the cost of creating one increases proportionately.

To better understand LLCs, let us look at its characteristics as they relate it to sole proprietorship, partnership, and corporation.

Sole Proprietorship Characteristic

One or more individuals or business can be member (owner) of an LLC. In the event that one person (including other artificial persons) owns an LLC, the LLC can be disregarded as an entity for tax purpose. Although a set of accounting books must be maintained separately for the company, its resulting year-end financial statements may have to be brought to the member's tax returns for data consolidation purpose. For an individual taxpayer, for instance, the business tax return will be a schedule attached to the member's IRS Form 1040.

Partnership Characteristic

In situation where the LLC has more than one member, it will not be disregarded even for tax purpose. Instead, management can opt to file tax returns as a partnership. The LLC still keeps its limited liability feature while filing as a partnership. This LLC will not pay business tax per se, but its members have to report the business profit and pay the appropriate tax at the individual level.

Corporation Characteristic

It must be understood that filing an LLC's return on its single member's tax return does not preclude it from being a separate entity from its owner. Management may choose not to file as a disregarded entity at all by electing to file as a corporation. LLC with one or more member can elect so filing with the Internal Revenue Service. Then, the LLC return must be filed on IRS Form 1120.

Note. New York State requires any LLC to pay a filing fee annually, prior to filing its tax return.

Not-for-Profit Organization

A not-for-profit organization is an entity created without any profit goal outside of the welfare of people in need. Not-for-profit organizations are usually corporations with a board of directors or trustees presiding over management.

A Not-for-profit organization is very different from other type of entities. There is also ownership confusions among management within those types of organizations. The fact of the matter is that they don't have owners.

Churches are one of those types of not-for-profit organizations where the original pastor believes he is entitled to every piece of asset the organization owns. That is not nearly the truth. If the church were to close its door, the state's district attorney office usually dictates how to rid of any residual asset. One means of doing so is to distribute residual assets to other not-for-profit organizations.

Until very recently, a large number of small not-for-profit organizations were not even required to file tax returns if the Internal Revenue Service found them to be exempt from filing. Commencing in 2008, tax-exempt organization with gross receipts of $25,000.00 or less is required to file returns of some sort and make their returns public. At last, being a tax-exempt organization is another area many take for granted.

Not-for-profit organizations have to apply for tax-exempt status with the Internal Revenue Service. The status is not automatic, as many tend to believe.

Recordkeeping

Even though recordkeeping can be burdensome, it is to the benefit of the company to have a system in place to safeguard and maintain all records. In most instances, company's records must be stored for a minimum of three years after filing the tax returns for any year. When the company continues to benefit from the value of a particular asset, invoices and receipts for that asset must be kept safe until three (3) years after the asset is retired. For instance, capital asset used over the years may be depreciated on a yearly basis. Every year, the company deducts an amount representing the percentage of usage of that asset. Documentation showing historical cost (including addition and subtraction) on the asset's value must be safeguarded until three (3) years after the capital asset is retired. .

Keep in mind that if sufficient records are not available to conduct an audit, tax auditors will make a determination based upon available documentation. That may mean estimating receipts and deductions to arrive at an estimated profit that will be taxed. Such move can be disastrous to the company.

Now, let us visit some of the steps toward keeping and maintaining company's records.

Setting up Accounting Systems

An accounting system consists of a chart of accounts with Journals and rules and policies regulating how transactions should be recorded over time. Professionals with experience in a company's industry can determine almost every account necessary in the chart of accounts for future journal entries. As the company expands and tax laws change, adjustment will still be required to the chart of accounts.

In this computer era, there is plenty off-the-shelf software that can be used to setup accounting systems for any type of company. Management should procure itself of one of such software to reduce time requirement and the level of accounting knowledge necessary to make journal entries and produce reports. The software user will require the assistance of an accountant or a bookkeeper familiar with the software to setup the initial accounting system. Thereafter, almost anyone with basic accounting knowledge should be able to enter daily transactions.

Bookkeeping

We continue to use the “bookkeeping” terminology to describe transactions recorded and maintained in each account listed in the chart of accounts. In a relatively short period of time, those transactions can amount to hundreds and thousands of journal entries. By the same token, one can rapidly create a set of books. Now, it is fortunate that we can keep and maintain this countless number of transactions electronically through the use of accounting software. As a result, we can periodically choose to produce hardcopies of our choice. For instance, management may need to produce a report to determine the amount of sales for a specific period of time such as one week, one month, or one year. Appropriate reports can be produced almost instantly. In another instance, management may need to determine how much receivables were collect for a month. A report generated from the receivables account can reveal that information.

Bookkeeping can be a challenge for small business owners who don't always have all of the skills and resources available. However, steps can be taken to make sure that documentation such as bank statements, un-deposited cash logs, vendor paid receipts, and checks are kept in a safe place for the purpose of recording transactions. When the help becomes available, professional will have less of a basis to charge exorbitant fees for back log work.

Bank Statements

As soon as the business entity is created, the owner should go to his or her bank and open a business checking and saving accounts right away. This step will help differentiating personal from business money. The bank will send monthly bank statements to the company showing all cash received and deposited into the business bank account. If cash received were not deposited, contemporaneous logs must be kept to account for those revenues. If all daily cash received were timely deposited, then the bank statements can be used to account for all cash received.

Receipts and Checks

Receipts for cash paid at the car wash or closing statements for closing the purchase of a commercial building are used for the same purpose. It would be unfortunate to deposit all cash to the bank and throw away the receipts from the car wash because they were small expenses. As trivial as it may sound, every disbursement must be accounted for because it will be applied against revenues to reduce the amount of tax a company and/or its owner has to pay to the federal or state tax agency.

Most banks issue debit card to their customers. In the event that all receipts cannot be safely kept, the business owner and everyone with authorization to spend on behalf of the company should carry a credit card that can be charged as an alternative to keeping receipts. On occasions, though, additional steps may be required to determine the identity of the vendor on the credit or debit card statements.

At last, whenever possible, payment should be made by checks because checks establish a reliable source of documents for journal entries. Although banks are trying the distance themselves from returning canceled checks to customers, many banks continue to return them to business customers. When banks do away with returning canceled checks to customers, they will still continue to record credits and debits into the bank statements.

Financial Statements

Most small and closely held companies merely share their financial information with anyone outside the company. Exceptions are information used to file tax returns, to request loan from financial institutions such as banks, and to request line of credit from significant suppliers.

A Measurement of Company's Health

The owner of a small size company should put time aside to examine all financial statements. If it is not possible to set time aside, it would be beneficial to hire an accountant to explain the financial statements. Otherwise, the owner may not know about the health of the company until it is too late. Let's say, for instance, the Business Checking Account item on the Balance Sheet (another financial statement) indicates that the company has $50,000.00 in the bank. However, an employee authorized to buy equipments on credit shipped $5,000.00 worth of equipments, to his friend's house. When the bill comes, the company will pay the $5,000.00. To conceal the theft, the employee will make sure that the equipment is recorded in the books while the company has no possession of the equipment. Someone with financial statements expertise has the ability to detect such event before it repeats enough to drive the company into bankruptcy. Catching discrepancies early will lead to necessary corrections.

Financial statements are a range of critical accounting reports that management and outsiders used to learn about companies' going-concern. An example of financial statement is the Profit and Loss or Income Statement, which presents a summary of revenues, expenses, and profit for a specific period in time.

A Proof of Earnings

Someone with regular wages or salary can easily prove to a lending institution that he or she filed tax returns on a regular basis and he or she receives a paycheck periodically by providing pay stubs. A self-employed individual such as a partner in a partnership has to take additional steps to prove the same. The owner or sole shareholder of a closely held corporation should be able to prove that he or she files tax returns every year and receive a paycheck as well. However, position of power and neglect can prevent the shareholder from doing so. As a result, small business owner's loan application may be denied unless they can provide financial statements with a letter from their accountant indicating that financial statements are authentic.

A Proof of Ability to Pay

Small business owners eventually need to acquire an expensive piece of equipment or merchandise for resale. Without establishing a business relationship or ability to pay, suppliers will be reluctant to sell anything on credit. It takes a longer period of time than a business owner can wait to establish business relationships. Ability to pay can be proven within a couple of days if not hours by providing verifiable financial statements to the suppliers. This could be more than enough to establish a line of credit with suppliers and begin acquiring merchandise promptly.

A Required Document for Tax returns

To prepare annual tax returns, every business entity needs an Income Statement and a Balance Sheet. While the Income Statement provides information such as revenues and expenses, the Balance Sheet provides some other essential data. Depreciated assets are listed on the Balance Sheet and their historical values are used to compute depreciation, a significant reduction in income. In fact, the entire Balance Sheet may be required on some companies' tax returns.

Note. Tax auditors require financial statements such as Balance Sheet and Income Statement to begin determining how management arrives to the numbers on the tax returns. Absence of financial statements raises concerns on the tax auditor's mind.

Payroll

It must be mentioned that a great deal of small businesses never had to deal with hiring employees because they did not expand fast enough to require the internal help of additional employees. Shareholders of S Corporations have the options of becoming an employee of the company and they usually avoid becoming one. For owners of General Business Corporation, it is much more difficult to refrain from becoming an employee. In the absence of voluntary compliance, tax agencies may require them to take payment in form of salary. Otherwise, the company may be subject to additional payment of tax, interest, and penalties on tax that should have been withheld on the salary.

When a payroll system must be established, a process has to be in place to hire employees, pay them, withhold employment taxes on them, and remit all taxes in a timely manner.

Earlier, we mentioned that owners of sole proprietorships couldn't be employee of the company. This prohibition does not prevent them from hiring employees. Also, other business entities such as partnership, corporations, limited liability company, and even large trusts and estates that we avoided discussing here, can find themselves in situation where they have to hire help.

Introducing payroll to a company also brings with it dealing with employment tax at the federal and state levels. Only a limited number of small businesses can handle withholding and remittance of employment taxes on their own. Many have to hire professionals to assist them in hiring employees, processing payroll, and remitting employment taxes to the government. For those reasons, we will examine the steps toward dealing with payroll.

Hiring Employees

Regardless of the ranking status of the hiring employee, the company must take steps to show compliance with employment tax laws. Immigration as well as other federal and state forms must be completed and filed. In some cases, the employer must send some completed forms that meet certain criteria to tax agencies. Failure to do so may result in future penalties being assessed on the employer. Once employees are properly hired, payroll process can take place periodically and according to management policies within employment tax laws requirements.

Payroll Processing

Once again, accounting software can handle the payroll process for most small businesses. The most challenging steps are setting up the system and maintaining it to reflect employee turnover, and keeping up with changes in employment tax laws. With available skills and competence, a company can process payroll internally by using accounting software add-on. However, employment tax knowledge is required to avoid any costly deviation from compliance.

Payroll Pay Period

Payroll Pay period is a period of time, for which management promises to pay employees for service rendered to the company throughout employment. Tax agencies expect management of any employer to remit employment taxes withheld from employees on a weekly, monthly, or quarterly basis.

The most common pay period companies use is weekly. Governmental agencies tend to use a bi-weekly pay period. In instances where the owner is the only employee; monthly pay period is customary. Management has the discretion to establish pay period within the guidance of employment tax laws.

Taxation

Briefly, we will discuss some of the different types of taxes business entities pay.

Income tax

Individual taxpayer, sole proprietorship, and corporations must pay tax on income. The corporations' tax is more commonly referred to as corporate tax. While Individual tax rate fluctuates considerably, the sole proprietorship tax rate at the federal level is a straight 15.3% of net income. Depending on the income level, corporate tax can vary between the rates of 15 and 39% of net income. If a General Business Corporation has no net income for the year, it may be subject to a minimum tax.

However, most small business corporation is exempt from the alternative minimum tax (AMT) at the federal level.

Payroll Taxes

Payroll taxes are withholdings from employees' gross pay. Employers have to match a portion of these taxes to remit to tax agencies. When tax agencies determine that employment taxes were not withheld properly, they may proceed to assess additional tax, interest, and penalties on tax that should have been withheld. Employers who choose to handle their own payroll must consider those consequences.

For a sole proprietorship and a partnership with no employee, employment tax is not a concern at all because it is a nonexistent tax. Matter can change considerably as soon as the very first employee was hired. New York business may be subject, though, to the .34% MTA tax.
For an S-Corporation with no other employee than the shareholder, it depends on whether the shareholder wants to pay himself or herself with future distributions or salaries. If salary is the choice, then

employment tax must be withheld and remitted to tax agencies. Either way, one can argue that the tax will be paid.

For General Business Corporation, it is a little harder to argue that the company has no employee. The shareholder of a General Business Corporation receives no payment during years when no dividend was declared and paid. As a result, tax agencies can argue that whoever renders services to the company has to receive compensation. The Internal Revenue Service recommends that the officers (shareholder) pay themselves a reasonable amount of compensation.

Sales Taxes

In the small business world, sales tax has been misconstrued as a business tax. That is not true at all! The confusion is a result of vendors' struggles to compete. Vendors avoid listing the sales tax portion of the selling item to lead consumers to believe that their price is lower than the competition. Either way, consumers always pay the sales tax to vendors and vendors (companies) have the responsibility to collect it on behalf of the state tax agency. According to New

York State sales tax law, whether a vendor collects the tax or not, it has to be paid. Collecting sales tax is a responsibility vendors take upon themselves, as vendors of certain products and services.

Notices and Assessments From Tax Agencies

What should one do about tax notices and assessments received from the IRS and NYS DTF? Simply put, do not ignore them because they will never go away.

Warning About the Internal Revenue Service

IRS agents are expert in what they do and they have plenty of resources available to use toward collection. Ignoring a notice or an assessment from the IRS is not a wise decision. The service can ruin taxpayers' credit; withdraw money from one's bank account without any consent, and place levy and liens against assets.

It is recommended to have tax professionals contact the IRS whenever possible instead of doing-it-yourself. Tax professionals know best.

Warning About New York State Department of Taxation and Finance

Here is something very surprising, to say the least. Everyone knows about the Internal Revenue Service more than the tax department of their own state of residence. In fact, state tax laws are not very much taught in school. NYS DTF has the same power as the IRS. In general, any tax debt to the IRS may be related to a New York State tax liability. Once a matter is resolved with the IRS, it should be visited for NYS DTF as well. Doing so can minimize a taxpayer's liability to the state tax agency.

Do not ignore NYS DTF notices and assessments. Resolving an issue at the federal level may not eliminate state tax issues. Ignoring them will reduce, if not eliminate, your rights to appeal their decision.

The Suitable Small Business Type of Entity

As we approach the end of this awareness booklet, we will show why many entrepreneurs choose to operate their company as an S-Corporation instead of a sole proprietorship, a partnership, a limited liability company, or a general business corporation.

Sole Proprietorship

It costs almost nothing to create Sole Proprietorship, but the owner of the company is personally liable for the business debt without any limit. The absence of limited liability scares most educated entrepreneur away.

Partnerships

A General Partnership Costs slightly more to create even if the partners choose to avoid involving a lawyer in writing a partnership agreement for them. A Limited Liability Partnership has some limited liability features for limited partner while the general partner is not protected. Many entrepreneurs avoid partnership, as a whole, for lack or absence of limited liability and potential future disputes that are usually detrimental to the company's survival.

General Business Corporation

This type of business entity establishes complete separation between personal and business property. Properly incorporating and operating one's company as a general business corporation protect personal assets against business debt. However, double-taxation does away with general business corporation's attractiveness to small business investors.

Limited Liability Company (LLC)

LLC is a good servant. It can be whatever its members want it to be: Sole Proprietorship, Partnership, S-Corporation, and General Business Corporation. For small business investors, a properly organized LLC is too costly. It means spending a minimum of $1,500.00 within the first 12 months of creating the company. That includes an annual filing fee that New York may require from the LLC.

Nonprofit Organization

Not-for-Profit organizations are not profitable companies. Instead, many people create them with hope that the organization will guarantee them a lifetime job. This is true for many preachers that earn the trust of their followers well enough to continue leading them until retirement.

An essential step toward creating a not-for-profit organization is getting it to tax-exempt status. The latter status can cost as much as $750.00 for a small organization with less than $10,000.00 in gross receipt.

S-Corporation: The suitable small business entity

At the federal level, S-Corporation pays no income tax. Starting with tax year 2004, it pays no differential tax in New York State. There is a minimal fixed minimum tax a New York S-Corporation has to pay. Beyond that fixed minimum tax, an S-Corporation with no employee and no sales tax requirement pays no tax to any tax agency.

Conclusion

Compared to the unlimited liability of sole proprietorship and partnership, double-taxation of general business corporation, and the cost of organizing limited liability companies, *S-Corporation is*

The Suitable Small Business Entity.

It relatively requires a small amount of initial investment to incorporate and to maintain an S-Corporation throughout the years. S-Corporation carries a limited liability feature for shareholders. If the S-Corporation is not profitable, shareholders may receive loss to apply against other similar income. If the S-Corporation is profitable, shareholders only get taxed once on annual income.